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Officials Seek Transit Rescues

Total Exposure Could Be Up to \$4B

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By [Audrey Dutton](#), [Lynne Funk](#) and [Andrew Ackerman](#)

WASHINGTON — State officials and lawmakers Friday were holding emergency meetings and pressing the Treasury Department to rescue public transit deals facing billions of dollars of payments.

The moves came as investors seek to terminate leaseback deals that technically have defaulted because American International Group and other guarantors either have lost, or are in danger of losing, their triple-A ratings.

The public transit sector's total exposure from these deals, if they are called upon to pay investors, ranges from \$1.5 billion to \$4 billion, according to market sources.

"We've been trying to see if we can get an agreement with Treasury to have [these transactions fall] under the Emergency Economic Stabilization Act, under what we call the insurance section. We believe that we could come under that act," said Carol Kissal, chief financial officer at the Washington Metropolitan Area Transit Authority.

The agency could face up to \$400 million in payments on 16 sale-leaseback transactions that were done between 1997 to 2003, selling rail infrastructure worth more than \$1.6 billion, through which WMATA made \$100 million. In most of them AIG was the guarantor.

Chris Zimmerman, chairman of WMATA's board, said the federal government should step in to help transit agencies.

"I think it is important that when the federal government looks at how they're dealing with the financial crisis that we're in that they don't forget that it's not only the banking sector but also aspects of the public sector that are downstream and are affected by this flood," Zimmerman said.

Both Kissal and Zimmerman said that they think Treasury could simply guarantee AIG.

"The bottom line to this is if Treasury was able to stand and back AIG there would be no problem, no cost, no payouts, no taxpayer money going out the door," Kissal said.

Treasury officials agreed Friday to meet with WMATA officials and their representatives tomorrow. House Speaker Nancy Pelosi, whose district includes San Francisco, is scheduled to talk to officials from Bay Area Rapid Transit tomorrow also. Transit officials have been working with lawmakers and their staffs to try to get some legislative help in any stimulus package that Congress considers later this year.

Ironically, the transit deals' troubles may have been prompted or accelerated by recent Internal Revenue Service action.

Under these tax-advantaged leaseback transactions done from about 1996 to 2003, sometimes called sell-in/lease-out or lease-in/lease-out deals, governmental entities including transit agencies, counties, and cities sold or leased an asset such as transportation equipment to a private entity, in

exchange for cash, usually about 3% to 6% of the asset's value.

The government or its agency typically got an up-front payment. The private entity was able to write off the depreciation costs of the equipment on its federal taxes while leasing the equipment back to the municipal entity. When the lease ended, the asset would revert back to municipal ownership for a nominal fee. The Federal Transit Administration approved these deals between 1998 and 2003, according to the American Public Transportation Association.

The IRS designated LILOs as "listed transactions" or abusive tax shelters in 2000, and added SILOs in 2005. The government then pursued lawsuits challenging the deals, claiming their only purpose was to provide tax benefits to private parties.

IRS Commissioner Douglas Shulman on Aug. 6 offered to settle with corporate taxpayers who had participated in the LILO and SILO transactions. The settlement, entered into by 30 companies of the 45 to which the offer was extended, required companies to agree to return 80% of the tax savings they realized under lease-back transactions.

Kissal noted that banks holding the LILOs and SILOs would have to comply by the end of this calendar year or be subject to severe penalties by the IRS.

"Most of the banks, probably 80%, are settling with the IRS on these transactions," she said. The banks that would keep only 20% of the tax benefits after settling "have the ability to recover that 80% loss by triggering these termination events with the transits," she said.

"I view that as tax policy that the IRS has put together that is flawed," Kissal said. "They don't realize that there is a resulting negative impact to public entities and that's the issue that needs to be addressed."

Kissal said that after AIG was downgraded, WMATA started to hear from the banks.

"Many of our banks have been patient," she said. "With most of these transactions, because of the downgrade, it triggers us to replace AIG. But currently there is absolutely no product on the market for us to replace them with."

Kissal said most of the banks had been providing WMATA "waivers as we continue to develop solutions," but that one bank, which she would not identify, but which is reported to be KBC Group of Belgium, told the agency they would have to make a \$43 million termination payment by next week.

"And then most recently, we've had this event of default notice, which we had not expected," Kissal said. "We had been working with them since September, so this came as a shock to us."

At least 31 transit properties in 18 states have exposure from entering into the lease-back deals, according to market sources. The top 10 transit issuers most active in the deals are beholden to leases held by at least 23 foreign and domestic banks, including AIG, and at least one private company, according to Jeffrey Boothe, partner at Holland & Knight LLP who is representing some of the local governments and authorities.

Leaseback deals are not limited to transit assets, but also include sewage plants, water treatment facilities, government buildings and other assets, which means a latent flood of technical defaults could be on the way.

The deals in which AIG was guarantor may represent the tip of the iceberg in the transit area, according to Boothe. Financial Security Assurance, Inc. and Ambac Financial Group, Inc. were also guarantors for the leases.

"The downgrade of AIG is the first one of the guarantors to trigger the technical default," Boothe said. "The belief is that FSA will soon be in that category as well. As they take more hits, and more and more issues arise, others will follow AIG."

Fitch Ratings put the AAA-rated FSA on negative watch this month, but in its news release in response FSA pointed to the rating agency's statement that if it downgrades FSA, the rating is unlikely to fall below AA.

Moody's Investors Service put Ambac's Aa3 ratings on review for downgrade last month.

Boothe disagreed with the notion that IRS decisions prompted the banks' notices of default.

"What was really the triggering event was the downgrade of AIG, but the settlements combined with [the downgrade] would cause investors to, shall we say, be a bit more aggressive to use the technical default as the basis to make a strong case for why they should be made whole," he said. "If they were able to retain their tax benefits, they may not have been so aggressive."

Investors saw it as a "moment of opportunity" to improve the liquidity by walking to the technical default, he said.

"It just happens WMATA is first in line to have this trigger," a congressional source said Friday. "If WMATA is forced to pay \$25 million today or next week, you can bet some banks that are short on cash are going to trigger their provisions."

"This has the potential consequence of closing down whole [transit] systems," the source added.

The Federal Transit Administration originally promoted SILOs and LILOs in its innovative financing handbook for transit agencies, said Mantill Williams, spokesman for the American Public Transportation Association.

And if the Treasury Department doesn't intervene, public transportation agencies "will face cutting services," he said. He argued that if Treasury backs AIG's letters of credit under its new authority, the credit ratings would return to AAA and the defaults would no longer exist.

Rob Healy, vice president of government relations for APTA, said the Treasury Department would incur "no risk" from intervening in the default situation, because transit agencies have a solid record of making payments from Treasury bills.

If the defaults continue, however, it will "adversely affect transit agencies' ability to issue bonds for ongoing projects. So you have a cascading effect," Healy said.

The Regional Transportation Authority of Illinois and its service boards face exposure on about \$100 million of the \$2.2 billion worth of lease-leaseback transactions they undertook beginning in 1995 and continuing until 2002. The 12 transactions all run for terms of between 30 and 40 years and involve garages, rolling stock, technical equipment, and a light-rail line, said RTA chief financial officer Joseph Costello.

AIG provided a guarantee behind the agency's lease payments to its counterparties on many of the transactions, but in most cases the terms required AIG only to post collateral in the event of a downgrade.

In the case of four transactions, three involving the RTA service board the Chicago Transit Authority and one involving its Metra commuter rail, the terms of AIG's guarantee allow the counterparties on the transactions to terminate the lease in the event of a downgrade.

Costello said CTA and Metra officials have been in contact with the counterparties and asked them to delay any action as the transit agencies seek a national solution. "We are optimistic that there will be a national solution with Treasury stepping in to provide a guarantee," Costello said.

When the CTA entered into what it believed was the first such leasing transaction involving an entire light-rail line in 1998, officials contended such transactions did not pose any financial risks. Although the transactions appeared complicated, experts in lease accounting said the mechanics were simple — both parties benefited at the expense of the federal government. The deals provided each participant with a strong financial incentive. Private investors at the time gained a tax shelter, because they are allowed to depreciate their assets under federal tax law, something public agencies cannot do. Public transit agencies leased back the asset at a favorable rate and received a quick infusion of cash.

New York's Metropolitan Transportation Authority entered into four lease sale transactions on Dec. 12, 2002, on which AIG Matched Funding Corp. was guarantor. Equipment for automated fare collection on the subway system was sold by MTA to third parties for \$507.4 million who leased it back to MTA.

The net benefit to MTA after the transaction was done was \$57.6 million. The downgrade in September of AIG triggered default events on two of those four, giving MTA until the end of the month to find a resolution. MTA finance director Patrick McCoy said the authority is negotiating with the Regents Bank and Bank of America to find a solution. Possible solutions include finding another AAA insurer, getting an LOC, or some other solution not yet known.

The Los Angeles County Metropolitan Transportation Authority runs one of the nation's largest public bus systems, a 73-mile rail system, and funds local highway improvements.

Metro took its leaseback proceeds and prefunded its lease payments, for a price slightly lower than the sale proceeds, said Terry Matsumoto, chief financial services officer and treasurer of the authority.

"The difference was our up-front benefit, which we used for capital in most cases," he said.

In all, Metro participated in 10 "defeased lease" transactions, with a nominal value of more than \$1 billion, though they generated a total of \$65 million for Metro, according to a staff report prepared by Matsumoto for a Metro committee meeting this month. AIG was involved in eight of those deals providing guaranteed investment contracts or letters of credit, the report said.

"The [guaranteed investment contracts] are fully collateralized with agencies and Treasuries," Matsumoto said. "How much more solid could AIG's position be?" he said.

"Since we believe that the investors' overall risk exposure is perhaps better today than it was at the beginning of the deal, we're hard pressed to say we should incur any amount of expense to cure this," he said.

Even though the investors' position is secure, the AIG downgrades still triggered contractual language, Matsumoto said. "You give the investors the right to make certain draws to reimburse themselves for the lost tax benefits," he said.

Replacing AIG as a GIC or credit provider is difficult, particularly since all the agencies involved in leaseback deals with AIG are trying to do so at the same time.

"It's causing all of us to go after very limited credit and a very limited market at the same time," he said.

Matsumoto agreed with public transit lobbyists that it would be appropriate for the federal government to step in, particularly since the GICs are funded with Treasuries and agencies, and the bailout bill gives it the authority to do so.

"We think that if the federal government, say the federal Treasury, would step up and guarantee our positions, guarantee us as a public transit agency we would perform on this deal, we'll give them the collateral in their own money," he said. "It's a very doable solution."

Yvette Shields, Rich Saskal, and Ted Phillips contributed to this story.

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